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Nos. 40, 41, 42

In the Supreme Court of the United States

OCTOBER TERM, 1942

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE OHIO LEATHER COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE STRONG MANUFACTURING COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WARREN TOOL CORPORATION

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

In the case of The Ohio Leather Company, No. 40, the opinion of the Board of Tax Appeals (Ohio,

R. 7–10)[1] is not reported, and the memorandum opinion of the Circuit Court of Appeals (Ohio, R. 19) is reported in 124 F. (2d) 397.

In the case of The Strong Manufacturing Company, No. 41, the majority and minority opinions of the Board of Tax Appeals (Strong, R. 14–16) are reported in 41 B. T. A. 1273, and the opinion of the Circuit Court of Appeals (Strong, R. 43–49) is reported in 124 F. (2d) 360.

In the case of Warren Tool Corporation, the opinion of the Board of Tax Appeals (Warren, R. 22–23) is not reported, and the memorandum opinion of the Circuit Court of Appeals (R. 31) is reported in 124 F. (2d) 397.

JURISDICTION

In each of these cases, the decree of the Circuit Court of Appeals was entered December 9, 1941 (Ohio, R. 19; Strong, R. 42; Warren, R. 31). The petitions for writs of certiorari were filed March 5, 1942, and were granted April 6, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In No. 40, the taxpayer was obligated under a bond indenture to pay to a trustee for each calendar year an amount equal to ten per centum of its net

[1] In this brief unless otherwise indicated we shall cite the record in No. 40 as Ohio; in No. 41 as Strong; and in No. 42 as Warren.

earnings for that year, but was not required to make the payment before April 1st of the succeeding year. For the year 1936, however, it in fact made the payment during 1936, and sought a credit therefor with respect to its undistributed profits tax for that year.

The question presented is whether the amount so paid was an amount "required * * * to be paid * * * or to be irrevocably set aside within the taxable year" within the meaning of Section 26 (c) (2) of the Revenue Act of 1936.[2]

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in Appendix A, *infra*, pp. 31–35.

STATEMENT[3]

1. *No. 40, Helvering* v. *The Ohio Leather Company*

As of January 1, 1936, The Ohio Leather Company issued debentures in the amount of $900,000

[2] The questions in Nos. 41 and 42 are substantially identical. In No. 42, the provisions of the contract required the payment of 25 per centum of the net earnings of the calendar year on or before April 1st of the succeeding year; and in No. 41, a note and mortgage agreement required the taxpayer to apply 40 per centum of each calendar year's net earnings upon the unpaid balance of its obligation, settlement for this amount to be not later than April 15 of the succeeding year. In both cases payment was in fact made during the calendar year.

[3] In the statements for these three cases, the record references contained in the parentheses are to the record for the particular case indicated by the subheading.

to mature in ten years pursuant to a certain trust indenture (R. 7, 8). Under the terms of this indenture, the corporation was required, for sinking fund purposes, to pay to the trustee on January 1st of each year, beginning with the year 1937, the sum of $25,000, and in addition on or before the first day of April of each year, beginning with the year 1937, "an amount equal to ten percent (10%) of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December" (R. 7–8). It was also provided that in lieu of payment of cash into the sinking fund, the corporation might deliver to the trustee debentures which had previously been issued and which the corporation had reacquired (R. 8).

During the year 1936, $81,000 of these debentures were purchased by the taxpayer at a cost of not less than the principal amount thereof, and on December 16, 1936, debentures having an aggregate face value of $47,000 were deposited with the sinking fund trustee, $25,000 of which were required under the bond indenture to be paid on or before January 1, 1937. The remaining $22,000 represented approximately 10 per centum of the net earnings of the taxpayer for the calendar year 1936, which was required to be paid into the sinking fund "on or before the next succeeding first day of April" (R. 8). The $22,000 deposit was made in 1936 rather than in 1937 in order to obtain

the benefits of Section 26 (c) (2) of the Revenue Act of 1936 (R. 9). The corporation's net earnings, as defined by the trust indenture, for the calendar year ending December 31, 1936, were $209,493.62 (R. 9).

In computing the surtax on undistributed profits imposed by the Revenue Act of 1936, the corporation claimed a credit under Section 26 (c) (2) of $20,949.36, 10 percent of the net earnings for the year 1936. The Commissioner of Internal Revenue disallowed the credit. (R. 2, 3.) The Board of Tax Appeals held that the corporation was entitled to the credit claimed, and that the proposed deficiency was erroneous to the extent that such credit had not been allowed. A small uncontested deficiency was entered against the corporation. (R. 10.) The Circuit Court affirmed the decision of the Board (R. 19).

2. *No. 41, Helvering* v. *The Strong Manufacturing Company*

In 1932, The Strong Manufacturing Company became obligated upon a note in the amount of $50,000 which was secured by a mortgage (R. 10–11). The note was to be paid in eight annual installments of varying amounts, payments to commence April 15, 1934 (R. 11). In addition, the obligation provided that 40 per centum of the corporation's net earnings in any calendar year was to be applied to the unpaid balance of the note

(R. 11, 12), but the payment of this additional sum was not required until April 15th of the succeeding year.[4]

On January 1, 1936, the corporation owed $47,000 on the principal amount of its indebtedness. During the year 1936, it retired its obligation by payment of $46,500, the obligee waiving the balance of $500 and also waiving a small amount of interest (R. 14). This sum of $46,500 was paid

[4] The pertinent provision (R. 12) reads as follows:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; * * *

"Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

In the court below, the Commissioner contended that the obligation was to pay only the amount of the earnings by which 40 per centum of such earnings exceeded the prescribed annual installment, and that since there was a duty to pay the installment of $5,000 for 1936 irrespective of the existence of earnings in that year, there was a separate reason for disallowing $5,000 of the credit claimed under Section 26 (c) (2). The court below held, however, that the $5,000 was in fact paid out of net earnings, and that therefore the taxpayer was also entitled to credit for that amount (R. 49).

on the following dates and in the following amounts (R. 14):

2/15/36	$2,500	7/31/36	$1,000
4/15/36	2,500	8/14/36	500
5/15/36	500	8/31/36	2,000
5/20/36	1,000	9/15/36	500
6/15/36	500	10/15/36	34,000
6/29/36	1,000		
7/14/36	500	Total	46,500

By September 30, 1936, the corporation's approximate profits were $86,000. Since it appeared that the profits would be such that 40 per centum would be in excess of the amount required to pay the note in full, the corporation decided to make the payment at that time (R. 14).

In computing the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, the taxpayer claimed a credit of $47,000 under Section 26 (c) (2). The Commissioner of Internal Revenue disallowed the credit (R. 6), but the Board of Tax Appeals held that the taxpayer was entitled to a credit of $46,500 (R. 14–15). A small deficiency was entered against taxpayer upon uncontested issues (R. 16–17). The Circuit Court of Appeals affirmed the decision of the Board (R. 42).

3. *No. 42, Helvering v. Warren Tool Corporation*

On November 1, 1932, the Warren Tool Corporation executed a first mortgage and deed of trust securing bonds issued on that date in the amount of $65,000. Between November 1, 1932, and January 1, 1935, additional bonds in the amount of $18,-

000 were issued and on January 1, 1935, $68,000 of bonds were outstanding (R. 17–18). The mortgage contained a sinking fund provision which required the taxpayer on and after April 1935, to pay to the trustee "on or before the 1st day of April of each year * * * a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding." Provision was made for the deposit of bonds in lieu of cash (R. 18).

The corporation had no net earnings in 1934 and, accordingly, no sinking fund payment was made in 1935. For the calendar year 1935, its net earnings were $15,020.84 so that the required deposit was $3,755.21. Payment was made on March 23, 1936, by the deposit of bonds in the amount of $5,500, which had been purchased by the corporation (R. 18).

In December 1936, the corporation's accountant estimated that its net earnings for the year 1936 would be about $50,000. At that time, therefore, it delivered to the trustee $12,500 of its first mortgage bonds for which it had paid $12,755. In February 1937, the corporation notified the trustee that its net earnings for the calendar year 1936 were $44,068.90 and that the payment owed to the trustee was $11,017.22 which had already been satisfied by the December payment (R. 18–19).

In December 1937, the corporation's accountant estimated that its net earnings for the year 1937

would be about $50,000. It delivered to the trustee $10,000 of its first mortgage bonds for which it had paid $10,000. Later in the same month, the corporation, upon reconsideration, estimated that its net earnings for the calendar year 1937 would be about $52,000, based on the accountant's revised report. On December 28, 1937, it delivered to the trustee an additional $4,000 of its first mortgage bonds for which it had paid $4,000. The accountant thereafter determined that the net earnings of the corporation for the year 1937 were $52,214.10, and that, therefore, the sum of $13,053.52 constituted the amount due under the agreement; this amount had been paid by the deposit of first mortgage bonds in the amount of $14,000 in December 1937 (R. 21, 22).

In computing the surtax on undistributed profits imposed by the Revenue Act of 1936, the corporation claimed a credit under Section 26 (c) (2) of $11,017.22 for the year 1936, and $13,053.52 for the year 1937. The Commissioner of Internal Revenue determined that these credits should not be allowed and proposed to assess the resulting tax deficiencies (R. 3, 7). The Board of Tax Appeals held, however that the taxpayer was entitled to the credits claimed, and that the proposed deficiencies were erroneous to the extent that such credits had not been allowed. Small deficiencies were entered against the taxpayer upon uncontested issues (R. 23). The Circuit Court affirmed the decision of the Board (R. 31).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in each of these cases in holding that the taxpayer corporations were entitled to credits under Section 26 (c) (2) of the Revenue Act of 1936 in the computation of their surtax on undistributed profits.[5]

SUMMARY OF ARGUMENT

Section 26 (c) (2) of the Revenue Act of 1936 provides, *inter alia*, that a corporation shall be entitled to a credit with respect to its undistributed profits tax if it has entered into a contract which requires that a portion of its net earnings and profits either be paid within the taxable year in discharge of a debt or be irrevocably set aside within the taxable year in discharge of a debt. Since the section grants a credit in the nature of a deduction, it must be strictly construed and taxpayers must carry the burden of showing compliance with its terms. There was no such showing here. In each of these cases, although taxpayers were obligated to pay a portion of their net earnings of the taxable year, their contracts did not require payment until several months after the close of such year; tax-

[5] In the case of The Ohio Leather Company, the court below erred in holding that the corporation was entitled to a credit of $20,949.36; in the case of The Strong Manufacturing Company, it erred in holding that the corporation was entitled to a credit of $16,500; and in the case of Warren Tool Corporation, it erred in holding that the corporation was entitled to a credit of $11,017.22 for the year 1936 and of $13,053.52 for the year 1937.

payers were not therefore *required* to make payment within the taxable year. Nor did the contracts require that taxpayers irrevocably set aside the specified percentage of their net earnings within the taxable year in which their earnings arose. The contracts made no provision for setting aside. The only contractual requirement was that taxpayers make payment after the close of the taxable year; until the specified date of payment they were free to use the net earnings as they saw fit.

The legislative history of the tax on undistributed profits confirms the conclusion that taxpayers were not entitled to a credit. That history establishes an intent rigidly to circumscribe the conditions under which a credit is available. Throughout consideration of the bill, Congress insisted upon limiting credits to a sharply defined minimum. It expressly refused to afford broad credits in the case of allocation of earnings to the payment of debts. In addition, the legislative history establishes that Congress expressly insisted upon providing credits only where the required conditions occurred *within the taxable year*. The House Bill originally provided for credits in case of payments of dividends during the "dividend year." The term "dividend year" covered the period of March 15 of the taxable year to March 14 of the following year, and its purpose was to afford a taxpayer corporation time to cast up its accounts and determine the distribution of its net

income. Nevertheless the term "taxable year" was subsequently substituted for "dividend year." Although the problem of computation of earnings during the taxable year so as to allow payment within that year was repeatedly called to the attention of Congress, Congress insisted upon retention of the requirement that payment must be made within the taxable year.

ARGUMENT

TAXPAYERS WERE NOT ENTITLED TO CREDITS SINCE THE AGREEMENTS DID NOT CONTAIN ANY PROVISION REQUIRING EARNINGS OF THE TAXABLE YEAR TO BE PAID OR IRREVOCABLY SET ASIDE WITHIN THAT YEAR

In each of these cases the taxpayer corporation contracted to apply a percentage of its net earnings of a particular calendar year to an indebtedness of the corporation; in each case the agreement expressly provided only that the payment of the specified percentage was to be made on or before an appointed date—April 1 in the case of The Ohio Leather Company and Warren Tool Corporation, and April 15 in the case of The Strong Manufacturing Company—in the year following the calendar year during which the net earnings arose. By virtue of these contracts, taxpayers have sought to avail themselves of the credits authorized by Section 26 (c) (2) of the Revenue Act of 1936 (Appendix A, *infra*, pp. 32–33), which relieves from the tax on undistributed profits any profits which may not be distributed because of a contract

requiring that a portion of earnings of the taxable year be paid or irrevocably set aside *within* the taxable year for the discharge of a debt. Since this section grants a credit in the nature of a deduction, permitted only in sharply circumscribed circumstances, it must be strictly construed, and taxpayer must carry the burden of showing compliance with its precise terms. *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46; cf. *White* v. *United States,* 305 U. S. 281, 291. We submit the taxpayers here have failed so to comply, and that they were not, therefore, entitled to the credit provided.

1. Section 26 (c) (2) expressly and rigidly limits the conditions under which a corporation which devotes its earnings or profits to the payment of debts rather than to the payment of dividends is entitled to relief from the tax on undistributed profits. As specific conditions precedent to the credit, (1) there must be a written contract executed by the corporation prior to May 1, 1936; (2) this contract must contain a provision expressly dealing with the disposition of earnings and profits of the taxable year; and (3) the contract must also contain a provision requiring that a portion of such earnings and profits either (a) be paid within the taxable year in discharge of a debt or (b) be irrevocably set aside within the taxable year in discharge of a debt. A taxpayer whose contract satisfies each of these three requirements is entitled to a credit to the extent of the amount which has

been so paid or irrevocably set aside.[6] Thus it will be seen that a sharp and exact line is drawn to separate corporations eligible for the credit from those ineligible; even though a corporation on one side of the line may be in a position no different for business purposes from a corporation on the other side, the one may be entitled to the credit and the other not.[7] The situation under Section 26 (c) (2) is thus like that under Section 26 (c) (1), where the effective prohibition against the payment of dividends does not entitle the taxpayer to a credit unless it is the precise type of prohibition required by Section 26 (c) (1). *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46.

Taxpayers in these cases have met the first of the two statutory requirements except as noted in the margin:[8] The written contracts antedated May 1,

[6] Section 26 (c) (2) is complementary to Section 26 (c) (1) (*infra*, Appendix A), which provides for a credit in the case of certain contracts which expressly prohibit the payment of dividends. It will be noted that the credit provided in Section 26 (c) (1) is not dependent upon the existence of a debt, while the credit allowed by Section 26 (c) (2) does not turn upon a contractual provision dealing with dividends. In the case of a contract which forbids the payment of dividends in order that a debt be discharged and which requires that there be payment or an irrevocable setting aside within the taxable year of earnings of the taxable year, the corporation is entitled only to the largest of the credits and cannot take credits under both subsections. See Section 26 (c) (1).

[7] For example, the agreement of a corporation may have been dated May 2, or, although executed before May 1, may be oral. Although the corporation may be just as effectively bound to pay debts out of earnings as a corporation with a

1936, and their provisions expressly dealt with the disposition and earnings of the taxable year. The third requirement, however, has not been met. In the case of the indenture of The Ohio Leather Company, the payment of ten per centum of the 1936 earnings to the trustee for sinking fund purposes was not required until April 1, 1937. In the case of the mortgage of Warren Tool Corporation, the payment of 25 per centum of the 1936 earnings, and the same percentage of the 1937 earnings, was not required until April 1, 1937, and April 1, 1938, respectively. The mortgage of The Strong Manufacturing Company similarly provided that the Company was to apply 40 per centum of the net earnings for 1936 in payment of the debt, but settlement was required to be made only by April 15, 1937.

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written agreement executed before May 1, the latter is entitled to a credit, the former is not.

* As to $5,000 paid in 1936, The Strong Manufacturing Company did not meet the second requirement, viz., that the contract must contain a provision which "expressly deals with the disposition of earnings and profits * * *"

The Strong Manufacturing Company contends that the contract required it to pay the installment of $5,000 in 1936 out of 40 per centum of the profits of 1936 to the extent that such percentage is sufficient to cover any or all of the sum of $5,000. But it seems clear that even under this interpretation of the agreement, which is contrary to the Commissioner's interpretation (see *supra*, p. 6, note 4), the corporation is not entitled to a credit for the $5,000 since in the words of the agreement itself, the corporation was "absolutely required" (R. 12) to pay $5,000 on April 15, 1936, *even in the event that there were no earnings.* A contract which re-

It is clear, therefore, that the express provisions relating to the time of payment of each of these agreements do not satisfy one condition of Section 26 (c) (2): The agreements required no payment until three months or more after the close of the taxable year, while the credit under Section 26 (c) (2) is available only if the payment must be made within the taxable year.

The court below, however, in its opinion in the Strong case (Strong, R. 43–49) held that a contract which requires a percentage of net earnings for a specified year to be paid on a certain date in the succeeding year nevertheless fulfills the conditions of the Act since such a contract requires an irrevocable setting aside in the taxable year within the meaning of Section 26 (c) (2). Its conclusion was based not upon any fact peculiar to any one of the contracts*; it was, rather, apparently based upon the broad proposition that any contract by which a corporation agrees that it shall pay a percentage of earnings of the taxable year, is, without more, a contract irrevocably to set aside such portion within

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quires a payment irrespective of earnings and profits cannot be said to deal expressly with the disposition of earnings and profits. See Article 26-2 (c) of Treasury Regulations 94, Appendix A, *infra*, p. 34. Since the $5,000 payment made on April 15, 1936, was made pursuant to a contractual requirement which had no express connection with earnings and profits, a separate reason exists for disallowing $5,000 of the $46,500 credit allowed The Strong Manufacturing Company.

* In its argument in the court below, The Strong Manufacturing Company urged that its agreement to "apply" 40 per centum of its net earnings, "settlement" to be by April

the taxable year, regardless of the date specified for payment.[10] But plainly no such conclusion is warranted either expressly or by implication. In contrast to their provisions relating to payment, each of the contracts is wholly silent in respect of any setting aside. The contracts do not in terms require the taxpayers to set aside the amount due, nor

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15 of the succeeding year, constituted an agreement irrevocably to set aside the 40 per centum in the taxable year. Although the court below adverted to this contention (Strong, R. 45), its holding could not have turned on the particular wording of the Strong agreement since it decided the other two cases, not involving similar language, upon the basis of the Strong opinion.

[10] Thus the court below stated (Strong, R. 45): "To sustain the respondent [Strong Manufacturing Co.], we are required * * * to construe the statute to the effect that "to set aside" means: to place in a separate fund; to carry under a separate entry or in a separate account; to transfer to a trustee; or some equivalent act of physical separation or appropriation of the profits, for the payment of the debt. If the statute provided that the corporation would be entitled to credit by virtue of a provision of a contract requiring it to keep, retain, or reserve, without right of revocation, a portion of its profits within the taxable year for the discharge of a debt, it would seem that respondent would be entitled to credit on the tax."

The court then held that Section 26 (c) (2) is to be construed so to provide. But the basis of its premise that the contracts required an irrevocable setting aside as so defined does not appear and it assumed, as stated in the text, that the bare agreement to pay a percentage of earnings for the taxable year satisfied the requirements. This assumption may have been based on the court's view that, as a practical matter in the normal operation of a business, an obligation to make a payment in 1937 would require a setting aside in 1936. Even if this were true, no "irrevocable setting aside"

do they require any segregation or physical retention at all. The only requirement was that the taxpayers pay on or before a date *after* the close of the taxable year. Up to that date of payment, there was no actual fund segregated and identifiable as "net earnings," which presumably consisted only of bookkeeping entries showing that current assets exceeded current liabilities for the year. As far as the agreements were concerned, therefore, until the date set for payment taxpayers were entirely free to use this "excess," along with other assets, for the purchase of new equipment, for investment, or for other appropriate purposes; if they were under any obligation whatever up to the date set for payment, it was only one, imposed by operation of law, to refrain from such a dissipation or distribution of the specified percentage of net earnings, which would put the percentage beyond the reach of the trustees or creditors. It is true that taxpayers did in fact "irrevocably set aside" within the taxable year the specified percentages by paying those percentages, but they chose the time of payment voluntarily and not pursuant to the requirements of their contract. Accordingly, since not compelled by an express provision of the contract,

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would be involved. And in any event, it would not be a setting aside "required by a provision of a written contract" as provided by Section 26 (c) (2). The section plainly provides that the setting aside within the taxable year must be required "by the terms of a written contract * * *." Regulations 94, Article 26 (c) (2), Appendix A, *infra*, p. 34. See *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 51–52.

the irrevocable setting aside did not satisfy the requirement of Section 26 (c) (2). *Antietam Hotel Corp.* v. *Commissioner*, 123 F. (2d) 274 (C. C. A. 4); *Helvering* v. *Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8).

The holding of the court below to the contrary—that the statutory condition that the contract require an irrevocable setting aside is satisfied by a contract which provides for payment of net earnings of the taxable year on a date in a subsequent year—renders meaningless the provision of Section 26 (c) (2) relating to payment within the taxable year. Plainly if it be held that any written contract executed before May 1, 1936, and requiring payment of net earnings of the taxable year automatically becomes a contract irrevocably to set aside such percentage, no matter how remote the date of payment, the words "to be paid within the taxable year" become wholly superfluous. For, under the construction suggested by the court below, the date for payment specified by the contract would be immaterial for all purposes, since, according to its view, the mere requirement of payment out of earnings of a given year entails a requirement that there be an irrevocable setting aside within that year. Such a construction does violence to the plain terms of Section 26 (c) (2).

2. The taxpayers, however, have urged, and the court below agreed (Strong, R. 46–48) that Congress could not have intended to withhold the credit provided by Section 26 (c) (2) from corporations

which have contracted to pay a percentage of net earnings of the taxable year on a date in the succeeding year. If, it is said, the credit were not allowed in cases such as these, the credit is illusory since few corporations are able to compute their net earnings of a taxable year until the succeeding year.[11] Accordingly, it has been urged, Congress must have intended that a credit be allowed here and the terms of Section 26 (c) (2) must be reformed to permit the credit.

We submit that the requirements of Section 26 (c) (2) are so plain and unambiguous that there is no occasion for resort to legislative history. But even were the text of the section less clear, its legislative history would not warrant the granting of a credit in the situations here presented. For that history establishes an intent to circumscribe rigidly and to define sharply the conditions under which a credit is due, and shows also an awareness that the credit was to be withheld in cases such as this.[12]

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[11] See Strong, R. 46; brief of The Strong Manufacturing Company in the court below, pp. 11–16, 20–33, 42–43.

[12] It may be noted that, in any event, the credit is not as completely unavailable as a practical matter as has been suggested. While we may assume that normally a corporation cannot precisely determine and pay a percentage of its net earnings until the year succeeding the taxable year, it could have contracted to pay during the taxable year upon the basis of quarterly statements, such as were submitted by The Strong Manufacturing Company to the trustee (Strong, R. 32); in addition, it is demonstrably plain that it was practicable to pay within the taxable year upon an approximation of net earnings—a course which each of the taxpayers followed here. See statement of Congressman Samuel B. Hill, 80 Cong. Rec. 10265.

The entire legislative course of the undistributed profits tax demonstrates that Congress intended severely to limit credits for a corporation's payment of debts and precisely to define the situation in which taxpayers were to be entitled to the credit. The Revenue Act of 1936 was introduced in the House of Representatives as H. R. 12395 (80 Cong. Rec. 5978); it proposed to eliminate entirely the normal existing taxes on corporate income and substitute a tax at rates graduated from zero to 42½ per centum upon undistributed net income (Section 13, Appendix B, *infra*, p. 36). Such undistributed net income was to be determined by deducting from net income the amount of dividends paid during the "dividend year" (Sections 13 and 27, Appendix B, *infra*, pp. 36, 39–40). In addition, credits were provided in certain situations where the corporation had deficits or debts: A corporation with a deficit at the beginning of the taxable year was to pay only a flat tax rate of 22½ per centum upon that portion of the undistributed earnings of the taxable year necessary to make up the deficit, and a tax at graduated rates upon the balance of the undistributed earnings of the taxable year (Section 14, Appendix B, *infra*, pp. 36–37); further, if the debts of the corporation exceeded accumulated earnings at the beginning of the taxable year, that portion of the earnings of the taxable year specified by the corporation for the yearly amortization of the excess during the next five years or more was taxed at the flat rates and the remainder at gradu-

ated rates (Section 16, Appendix B, *infra* pp. 38–39)."

Thus it will be seen that from the outset, credits in the case of debts or deficits were specifically limited, and even where the conditions were fulfilled, the tax at the flat rate was to be imposed upon the earnings which were applied to cover debts or deficits. And although the opponents of the bill in the House of Representatives attacked these provisions as affording insufficient relief in the case of debts, its sponsors insisted that the "cushions" were sufficient. See 80 Cong. Rec. 6004, 6212–6213, 6228, 6304.

The Senate Committee on Finance altered the form of the House Bill in major respects. The Senate Bill restored the existing general corporate income tax and substituted for the House graduated tax on profits not distributed through dividend payments a flat seven percent tax upon such undistributed profits. See S. Rep. No. 2156, 74th Cong., 2d Sess. (1936), pp. 5, 12. The Senate Bill omitted altogether credits for corporations with debts or deficits; instead it provided in Section 26 (c) only for a credit where a corporation had executed a written contract prior to March 3, 1936,

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" Section 15 (Appendix B, *infra* pp. [illegible]) also permitted a credit if the payment of dividends out of earnings during the "dividend" year was restricted by contract; such restricted earnings of the taxable year were to be taxed at the flat rate and the earnings free for dividend distribution, but not distributed, were to be taxed at the graduated rates.

which prohibited the corporation from paying dividends during the taxable year." This elimination of even the restricted credits provided in the House Bill was explained on the ground that the moderate rate of seven per centum made "the complicated relief provisions" unnecessary. S. Rep. No. 2156, 74th Cong., 2d Sess. (1936), p. 12.

As in the House, opponents of the bill, both at the hearings and in the course of debate, sharply criticized the failure to afford credits in the case of payment of debts. See 80 Cong. Rec., 9045, 10164, 10467. But the supporters of the view embodied in the bill were unconcerned with the problem of debts: They insisted that the moderate rate provided by the Senate made the credit unneces-

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[14] The present Section 26 (c) (2) was adopted without discussion or debate as an amendment proposed on the floor of the Senate toward the close of the consideration of the Bill; it was accompanied only by a statement of Senator Couzens (80 Cong. Rec. 9071) that it had been—

"generally discussed in the committee; and in view of the language of the bill there were left out, in the judgment of the committee, other forms of debts than those dealing with the payment of dividends. The last words on line 22, page 53 [the proposed Section 26 (c) (1) which afforded a credit in the case of a contract which prohibited payment of dividends "during the taxable year"] seem to exclude obligations of the corporation to pay debts or withhold earnings for specific purposes under contract.

"I have consulted those on the committee, and so far as the committee is concerned, there seems to be no reason for not adopting the amendment."

It is plain, therefore, that Section 26 (c) (2) was intended only to parallel and complement Section 26 (c) (1).

sary [15]; that fully to provide for credits for debt payments would make the raising of sufficient revenue impossible and would create large loopholes by which corporations could escape the tax [16]; and that there was no reason to discriminate between individuals, who received no credit for the payment of debts, and corporations.[17] And in fact an amendment introduced by Senator Adams to broaden the credit for payment of debts by providing a credit for all portions of adjusted net income "expended or applied during the taxable year for the liquidation, payment, or reduction of the principal of any bona-fide indebtedness outstanding at the date of the enactment of this Act" was rejected. 80 Cong. Rec., 9055, 9070.

It is plain, therefore, that Congress did not intend general relief in the case of corporate earnings utilized for the payment of debts; on the contrary, the sponsors and supporters of the bill which ultimately became the Revenue Act of 1936.

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[15] 80 Cong. Rec. 8649 (Senator King), 10467 (Senator Barkley).

[16] 80 Cong. Rec. 9056–9057, 9058, 10467 (Senator Barkley), 9070 (Senator Couzens).

[17] 80 Cong. Rec., 9056, 10467 (Senator Barkley), 10471 (Senator LaFollette); compare p. 10474 (Senator Connally). Supporters of the House Bill advanced the same analogy. See 80 Cong. Rec. 6228 (Mr. Buck). And it was further urged that the hardship of paying the tax on income which went for the payment of debts could be avoided by payment of taxable stock dividends, and utilization of the earnings for the payment of debts. See 80 Cong. Rec. 9045 (Senator LaFollette).

expressly opposed such relief." But the legislative history of the Revenue Act of 1936 not only establishes this general intent to keep credits to a sharply defined minimum; it shows also that relief was not intended to be afforded unless the required conditions occurred *within the taxable year.*

Thus, the problem of computing earnings before the close of the taxable year was expressly considered. As first introduced in the House of Representatives, the bill provided that undistributed net income was to be determined by deducting from net income the amount of dividends paid during the "dividend year." Where the taxable year coincided with the calendar year, the term "dividend year" covered the period of March 15 of the taxable year to March 14 of the following year. Sections 13 and 27, Appendix B, *infra,* pp. 36, 39–40. And this same provision was applied to the credit in the case of contracts prohibiting payment of dividends: The corporation was entitled to a credit if the con-

[16] For this reason, the suggestion advanced by taxpayers and the court below (see Strong, R. 46, 47) that the tax was intended to be imposed only upon corporate income which was not distributed at all must be rejected. For the entire course of the bill makes clear that the tax was intended to be imposed primarily upon income not distributed in the form of dividends; that it may have been "distributed" for other purposes, such as plant improvement and expansion, acquisition of new equipment, replacement of lost or destroyed equipment, or payment of debts was immaterial for purposes of credits.

tract prohibited the payment of dividends during the "dividend year." Section 15, Appendix B, *infra*, pp. 37–38. In explaining the purpose of the term "dividend year," Congressman Samuel B. Hill, chairman of the subcommittee of the House Ways and Means Committee, stated (80 Cong. Rec. 6005):

> It takes the corporation some time to cast up its accounts and determine just how much its net income is and how much it wants to distribute and how much it wants to withhold. If you make the dividend year coincide with the taxable year, they would have to have this all figured out before the end of the taxable year.

Nevertheless, Congressman Hill subsequently offered, and the House adopted, a committee amendment substituting the "taxable year" for the "dividend year." Congress thus plainly insisted that payments be made within the taxable year for entitlement to the credit. 80 Cong. Rec. 6308. And in subsequently adopting Section 26 (c) (2), it clearly was aware of the strict limitations which its inclusion in that section of the clause "within the taxable year" entailed.

Just as the taxpayers here and in the court below have urged the practical difficulties of computing earnings within the taxable year so as to qualify for the credit by making payment in that year, so were such difficulties urged before the Senate and the House of Representatives. Witnesses before the Senate Committee on Finance insisted that the

House bill was too restricted since it failed to provide for a period after the taxable year during which earnings could be computed and payments, qualifying the taxpayer for credits, could be made. Hearings before the Senate Committee on Finance on H. R. 12395 (74th Cong., 2d Sess.), pp. 385, 417–418. Yet the term "taxable year" was retained and the Senate added no amendment to satisfy the objections which had thus been called to its attention. And further, the present Section 26 (c) (2) using the term "within the taxable year" was, in fact, introduced as a Senate committee amendment (see *supra*, p. 23, note 14), after the hearings at which these objections had been made. The inference is plain that the section, therefore, was intended to provide a credit only in the case of a contract which explicitly required a payment or an irrevocable setting aside before the close of the taxable year in which the earnings had arisen. Similarly, after the bill had gone to conference and been reported out, the issue of difficulty of computation of earnings during the taxable year was again raised in the House of Representatives, and the following colloquy occurred (8 Cong. Rec. 10265):

> Mr. RICH. * * * If a corporation does not know what its earnings are going to be in 1936, is it going to be compelled to pay the surtax on all of its earnings, provided it does not pay the earnings to the stockholders in the year 1936?

Mr. SAMUEL B. HILL. That is correct. If it does not pay it out in 1936, it will pay a surtax on the undistributed portion.

Mr. RICH. There is not a corporation in the United States that earns over $100,000 that knows within 30 to 60 days after the end of the year what its earnings are going to be.

Mr. SAMUEL B. HILL. They will certainly know approximately what their earnings are.

Finally, that the credit provisions were intended by Congress to be carefully limited is made clear by the history of the Revenue Act of 1938, c. 289, 52 Stat. 447. The limited scope of Section 26 (c) had been the source of wide complaint, and accordingly, the 1938 Act retained a tax on undistributed profits only in a restricted sense (see Section 13) and included broader provisions for credits in connection with payment of indebtedness." But one of the

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" The Act provided:

"SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

"(a) *Definition in General.*—As used in this title with respect to any taxable year the term "dividends paid credit" means the sum of:

* * * * *

"(4) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind, if such amounts are reasonable with respect to the size and terms of such indebtedness. As used in this paragraph the term "indebtedness" means only an indebtedness of the corporation existing at the close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of

very reasons which led to these amendments in 1938 was stated by the House Committee on Ways and Means (H. Rep. No. 1860, 75th Cong., 3d Sess.) (1939–1 Cum. Bull. (Part 2) 728, 730) to be:

> The relief provisions applying to corporations having contracts not to pay dividends or requiring the use of current earnings for the payment of debts are so restrictive as to provide relief only in rare cases, although many other cases equally meritorious receive no relief.

It is against this background that Section 26 (c) (2) of the Revenue Act must be considered. Congress plainly was aware of, and insistent upon, its rigid limitation of credits for debt payments; it expressly refused to make provision for post-tax year computations and payments; and it was not until 1938 that it broadened its provisions, at the same time that it confirmed the limited scope of the earlier Act. In these circumstances, even were the words of Section 26 (c) (2) less unambiguous, its legislative history would preclude the granting of a credit in the situations presented by these cases.

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trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date. * * *"

The credit, accordingly, was made available without reference to the particular terms or requirements of the indebtedness.

CONCLUSION

The judgment of the court below should be reversed in each of these cases.

Respectfully submitted.

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APPENDIX A

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) Prohibition on Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a re-

quirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*— For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the

discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the

taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * *

APPENDIX B

Excerpts from H. R. 12395, 74th Congress, 2d Session, as introduced into House of Representatives:

SEC. 13. TAX ON CORPORATIONS.

(a) DEFINITIONS.—As used in this title—

(1) The term "adjusted net income" means the net income in excess of the credit provided in section 26 (relating to interest on certain obligations of the United States and Government corporations);

(2) The term "undistributed net income" means the adjusted net income minus the sum of—

(A) The dividend credit provided in section 27; and

(B) The tax computed under subsection (b).

(b) RATE OF TAX IN GENERAL.—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

* * * * *

SEC. 14. ACCUMULATED EARNINGS AND PROFITS LESS THAN ADJUSTED NET INCOME.

(a) GENERAL RULE.—If the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by this title for the taxable year) are less than the adjusted net income, the tax imposed by section 13 shall, in lieu of being

computed under section 13, be computed by adding:

(1) A tax of 22½ per centum of the adjusted net income over such accumulated earnings and profits; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) TAX NOT TO BE INCREASED.—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

SEC. 15. CONTRACTS NOT TO PAY DIVIDENDS.

(a) GENERAL RULE.—If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the dividend year without violating a provision of such contract expressly dealing with the payment of dividends, the tax imposed by section 13 shall, in lieu of being computed under such section, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over the amount which is not prohibited during the whole of the dividend year from being paid as dividends during the dividend year; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) TAX NOT TO BE INCREASED.—This section shall not be applied in any case in which such application would operate to increase

the tax which would be payable without its application.

SEC. 16. DEBTS.

(a) DEFINITION OF "DEBT."—As used in this section the term "debt" means an indebtedness of the corporation existing at the close of business on March 3, 1936, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on March 3, 1936, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date; to the following extent:

(1) If having a maturity at the time of issue of three years or more, then to the full amount thereof;

(2) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to represent indebtedness incurred by the corporation prior to March 4, 1933; or

(3) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to evidence indebtedness of the corporation incurred in the acquisition of capital assets, except (A) shares of stock in any corporation, or (B) rights to subscribe for or to receive such shares, or (C) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation, with interest coupons or in registered form, or (D) certificates of profit, or of interest in property or accumulations, in any investment trust or similar organization holding or dealing in any of

the instruments mentioned or described in this paragraph, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this Act.

(b) COMPUTATION OF TAX.—If the sum of all the debts computed under subsection a) of this section is in excess of the accumulated earnings and profits of the corporation as of the day before the first day of its first taxable year beginning after December 31, 1935, and if the corporation, in its return for its first taxable year under this title, specifies the number of consecutive taxable years (not less than five) over which such debt excess shall be amortized for the purposes of this subsection, then for such number of consecutive taxable years, beginning with the first taxable year of the corporation under this title (or if no such specification is made, then for the first ten taxable years) the tax imposed by section 13, in lieu of being computed under such section, shall be computed by adding:

(1) A tax of 22½ per centum of an amount of the adjusted net income equal to the amount of such debt excess divided by the number of years so specified (or, if no specification, then by ten); and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

* * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) DEFINITION OF "DIVIDEND YEAR."—The term "dividend year", when used in this title with reference to a corporation,

means the period beginning on the fifteenth day of the third month after the day before the beginning of the taxable year (whether the taxable year is a period of twelve months or a shorter period) and ending on the fourteenth day of the third month after the close of the taxable year.

(b) DIVIDEND CREDIT IN GENERAL.—For the purposes of this title, the dividend credit shall be the amount of dividends paid during the dividend year corresponding to the taxable year.

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